Tax Treatment of Charitable Trusts In Pennsylvania and New Jersey

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Background

Charitable remainder trusts (CRTs) have been used by taxpayers as a tax-favored way to earmark assets for future transfers to charitable institutions. CRTs are most commonly used by persons who plan to sell or otherwise dispose of highly appreciated assets. The grantor contributes the assets to the CRT, which later sells them. Under federal rules a charitable remainder annuity trust (CRAT) or charitable remainder unitrust (CRUT) created after July 31, 1969, is exempt from income tax except in the tax year it has income that would be unrelated business taxable income if it were an exempt organization. Therefore, any gain attributable to the property escapes federal income tax at the trust level.

That can best be illustrated with an example:

Assume a taxpayer is about to sell a block of highly appreciated stock in a private company that was about to be acquired. The sale price of the stock was $12 million, with a basis of $2 million resulting in a long-term capital gain of $10 million. Combined federal and state income tax would total $1,807,000 on the gain, leaving a net of $8,193,000.

If a CRT were established, the stock maybe “could be sold without incurring any federal and presumably any state income tax,” leaving a net of $12 million for reinvestment. Under the trust instrument, the CRT could provide that the taxpayer would receive unitrust payments for his life at a 5 percent rate based on yearly valuations of the trust assets.

Amounts distributed by a CRUT are treated as having the following characteristics in the hands of a beneficiary to whom the unitrust amount is paid:

- as ordinary income to the extent of the trust’s ordinary income for its tax year and its undistributed ordinary income for earlier years;
- as capital gain to the extent of the trust’s undistributed capital gain;
- as other income to the extent of the sum of the trust’s other income for the tax year and its undistributed other income for earlier years; and
- as a distribution of trust corpus.

The trust is required to distribute $600,000 and assume that all payments in year 1 come from ordinary income. Therefore, none of the capital gains will be distributed to the beneficiary, and there will not be a capital gains tax at the trust level for federal income tax purposes. Further, assume in year 2 that the ordinary income drops by 3 percent. The asset value remains at $12 million. The beneficiary will still receive a $600,000 payout. However, for federal income tax purposes, $360,000 of the payment will be ordinary income and $240,000 will be capital gains.

State Income Tax Under Pennsylvania Law

A resident trust is a trust created by the will of a person who was a resident at the time of his death, by a person who was a resident at the time the trust was created, or by a person who was a resident at the time he transferred property to the trust.

Under Pennsylvania statute, a charitable trust is a trust operated exclusively for religious, charitable, scientific, literary, or educational purposes. A trust is a charitable trust only if all net earnings for the tax year and remaining life of the trust are for

1IRC section 664(c)(2).
2That assumes the taxpayer is a resident of Pennsylvania.
3IRC section 664(b)(1).
4IRC section 664(b)(2).
5IRC section 664(b)(3).
6IRC section 664(b)(4).
distribution for such purposes. No part of the earnings of a charitable trust may benefit any private individual.\textsuperscript{8}

Moreover, the instructions for Form PA 41 indicate that federally qualified CRATs and CRUTs are not charitable trusts if, during the current tax year, any part of the trust's retained earnings benefit any private individual in subsequent years.\textsuperscript{9} Therefore, referring back to our previous example, under Pennsylvania rules, the full $10 million gain would be subject to Pennsylvania income tax at the trust level. (That assumes that the 5 percent distribution is totally from ordinary income; thus, the full gain is accumulated in the trust.) The trust would not qualify as a charitable trust, because a part of the trust's retained earnings will benefit a private individual in subsequent years. Thus, the tax would amount to $307,000 (that is, $10 million at 3.07 percent).\textsuperscript{10} Therefore, the net left for reinvestment would be $11,693,000, not the full $12 million. Thus, the $307,000 of tax paid is not available to work for the benefit of the trust and the charity. This will have a significant effect on cash flows from the trust. Moreover, the future value of the trust has been reduced.

In year 2, of the $600,000 payment, $360,000 will be taxable for Pennsylvania purposes and the remaining $240,000 will be a tax-free return of corpus. There is no accumulated capital gains for Pennsylvania income tax purposes. Some will argue that that results only in a timing difference. Although in some cases that may be true, it still has a significant effect on the charity.

It appears that the only way to avoid the Pennsylvania tax is to structure the CRT so that all the current income must be paid to the beneficiary. At the end of the day, this could be detrimental to the charity.

The trust could be entitled to a charitable deduction. However, the instructions for Form PA 41 provide that a trust qualifies for a charitable distribution deduction if it is required under applicable law or its governing instrument to retain and permanently set aside or credited to a charitable beneficiary is tax-exempt from New Jersey income tax under N.J.S.A. 54A:2-1, and income that is not distributed and that is not deemed to be permanently and irrevocably set aside or credited to a charitable beneficiary will receive gains or income.\textsuperscript{12} (See Burke, Clare and Hill, Trustees v. Director, 11 N.J. Tax 29 (1990).)

Only exclusively charitable trusts qualify for income tax exemption under the New Jersey Gross Income Tax Act. A CRT, in contrast to a charitable trust, has noncharitable beneficiaries and does not operate exclusively for charitable purposes. A trust cannot be deemed to be a charitable trust unless it is operated exclusively, during all of the tax years in question, for religious, charitable, scientific, literary, or educational purposes. A trust cannot be deemed to be a charitable trust unless it is operated exclusively, during all of the tax years in question, for religious, charitable, scientific, literary, or educational purposes; serves a public interest as opposed to a private interest; and, under the governing instrument, there is no possibility that a noncharitable beneficiary will receive gains or income.\textsuperscript{13} (See Burke, Clare and Hill, Trustees v. Director, 11 N.J. Tax 29 (1990).)

Referring back to our previous example, under New Jersey rules, the full $10 million gain is subject to New Jersey income tax at the trust level. (That assumes that the 5 percent distribution is totally from ordinary income, and thus the full gain is accumulated in the trust.) The trust would not qualify as a charitable trust because a part of the trust's retained earnings will benefit a private individual in subsequent years. Thus, the tax would amount to $973,180. The top rate in New Jersey is 9.9 percent.\textsuperscript{14} Therefore, the net left for reinvestment would be $11,026,820, not the full $12 million.

\textsuperscript{8}Pa Code 101.9 Trusts Pennsylvania.
\textsuperscript{9}See Form PA 41 instructions, p. 7.
\textsuperscript{10}There is a proposal to increase the rate from 3.07 percent to 3.37 percent.
\textsuperscript{11}See Form PA 41 instructions, p. 34.
\textsuperscript{12}See Technical Bulletin 64, New Jersey Division of Taxation, June 29, 2009 (Doc 2009-14966 or 2009 STT 128-14).
\textsuperscript{13}Id.
\textsuperscript{14}It is proposed for tax years beginning after 2008 and before 2010 that the top personal income tax rates for taxpayers with taxable income exceeding $400,000 will be 8 percent if taxable income is over $400,000 but not over $500,000; 10.25 percent if taxable income is over $500,000 but not over $1 million; and 10.76 percent if taxable income is over $1 million.
Thus, the $973,180 of tax paid is not available to work for the benefit of the trust and the charity. That would have a significant effect on cash flows from the trust. Moreover, the future value of this trust has been reduced.

**Conclusion**

A CRT enables individuals to support the country’s critically important charitable sector, often on a much more substantial scale than if their only option were to part immediately with all benefit from the donated property. There appears to be inherent inequities in the Pennsylvania and New Jersey laws to achieve that objective. It is hoped that Pennsylvania and New Jersey will amend their statutes to conform to the rules as they relate to a federally qualified CRT.\(^{15}\)

\(^{15}\)In the difficult economic environment and the corresponding budget situations of each state, reform appears to be unlikely.